Our National Bankig System

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The bank act was a compilation of the best results of a series of legislative experiments carried on by the States for three-quarters of a century.
It is necessary, therefore to study carefully the practical workings of the different State systems and of the early national banking systems.
Such a study will properly form a prelude to a more thorough examination of the present national banking system.
No monetary history is more instructive than ours. We have tried every variety of paper money at different times.
To our colonial ancestors a bank meant a "batch of paper money."
The issue of paper money is not con-

sidered by economists to be a legitimate function of banking; but we find that the issue of paper money by banks was early considered to be the most important function. Starting, therefore, with the erroneous theory that something could be created out of nothing the practice of issuing inconvertible paper money continued without cessation for more than eighty five years and culminated in the era of continental currency which went down in such frightful ruin in 1788.

The Constitution took away from the States the power of issuing bills of credit and the opportunity for restoring the public credit was not to be thrown away. It was fortunate for the country that Alexander Hamilton was at the head of the Treasury Department at that time. He was the exponent of the principle of a strong centralized government. Public credit and Union at the time were inseparably bound together. Congress called upon Hamilton to prepare a financial policy for the new government. As a part of his financial policy he proposed the establishment of a national bank to aid the Treasury in the collection and disbursement of the revenue, and in funding the public debt. There were then only three state banks in existence in the country.

The principal argument against a national bank was its unconstitutionality. The opposite party claimed that Congress having the undoubted power to pass laws necessary for the collection of revenue and laws might constitutionally charter a bank for that purpose.

Hamilton's plan was adopted and the First Bank of the United States was chartered for 20 years. At the time there was no national money except a few copper cent pieces.

The capital stock of the bank was limited to 25,000 shares of 400 dollars each payable, one-fourth in gold and silver and three-fourths in public securities bearing six and three per cent interest. Five thousand shares were held by the government. The money was popular and no bills were issued under ten dollars.

The opposition to the bank continued

throughout the period of its existence and before the expiration of its charter in 1811, eighty eight state banks had been organized and were able to prevent a renewal of its charter.

Mr Gallatin, then at the head of the Treasury favored a renewal of the charter because (1) there was no other institution that afforded such facility of transmission of the public money; (2) the superior capital of the institution afforded security against loss and greater resources for loans; (3) the government could not control the state banks and it was not therefore desirable to be dependent upon them. Opposition was grounded on the fact that foreigners held a greater part of its stock and that the bank was unconstitutional. It could, however, be said in favor of the bank that it had afforded a circulating medium, acceptable alike in all parts of the country. There was no doubt that there was an excessive amount of bills in circulation, but the transfer of the issuing power to the state banks would only increase the amount already in circulation to enormous proportions. The First United States Bank had checked the state banks in their disposition to overtrade by restraining their issues and holding them to a proper specie reserve.

The failure of the national bank to secure a re-charter was a signal for the rapid increase in the number of state banks. They were started on the principle of limited liability and were known as the "wild-cat" banks. Sudden contractions and expansions in the volume of paper money were inherent in the system. The ratio of paper money to the specie reserve was always a very high ratio and sometimes there was no specie reserve at all. During financial pressure or when commerce demanded gold, with the small amount of reserve on hand redemption was impossible. Very few banks were an exception to this rule during panics. The instability of such a system precipitated recklessness in business and frequent bankruptcies. The tendency had been to encourage speculation and extend credits in times of quiet, but when the pressure came promises were not fulfilled. Coins were kept out of common use and the bills of one locality were not current in another.

In the issue of paper money so flagrantly abused there was a repetition of the colonial experiments.

The depreciation of bank paper at the close of the war of 1812 reached 20 to 25 per cent and the suspension of the banks followed the capture of Washington by the British.

The New England banks alone maintained specie payments by the aid of the Suffolk Banking system of Massachusetts — extended throughout New England. In this system a certain sum was required to be kept in the suffolk bank, or some other central bank, for the redemption of circulating notes. This was the distinguishing feature of the New England paper money and the stability of the system was shown by the ease with which the disasters of all crises were averted.

The Treasury Department was involved in the common disaster, following the war, because of the refusal of the state banks to give accomodations.

The treasury note system was resorted to as an expedient and it proved as powerless to avert disaster as when it was resorted to during the civil war, before the establishment of the present national banking system.

Again, to bring order out of chaos the people demanded a national bank and the Second Bank of the United States was chartered in 1816 and went into operation in 1817, but too late to prevent the crash that followed. Specie payments were resumed but the state banks began to fail in 1818, and in 1819 there was another general suspension lasting for two years.

The capital of the new bank was fixed at \$35,000,000 in 700 shares of 100 dollars each. The government subscribed 7,000,000 dollars the balance being subscribed by individuals. Shares were payable, one-fourth in coin and three-fourths in the funded debt of the United States. Notes could not be issued under five dollars.

The state banks had been making money by suspensions and the strug gle of the United States bank for existence in the face of such difficulties was a hard one, but it finally triumphed and ten years of nearly unbroken prosperity followed.

The bank itself was far from perfect and many bad mistakes were made, generally because of mismanagement. Chief among the defects of the system was the issue of branch drafts.

These were drawn on the parent bank by the cashiers of the branch banks in denominations of five, ten, and twenty dollars. By the issue of these drafts the branch banks became indebted to the parent bank and the issues were thereby still further stimulated.

There were other defects of minor importance but all of these could have been remedied by the proper legislation. The defects were not due to any faults inherent in the system.

The bank question soon became a party issue and in 1830, six years before the expiration of the charter, the great "bank war" was waged between the friends and the enemies of the bank, resulting in the veto by President Jackson of the bill to re-charter. The Second Bank of the United States had become a political machine, and no doubt deserved to perish; nevertheless it had rendered important services to the country, and the government lost not a dollar by either of these institutions, but received from the bank of 1791 a net profit of 1,137,152 dollars and from the bank of 1817, a net profit of 6,093,167 dollars.

The government deposits had been withdrawn from the bank of the United States in 1833 and placed in several state banks possessing a specie reserve of one-third of their circulation.

The state banks once more assumed control of the currency and speculation on a stupendous scale followed, resulting in the memorable crisis of 1837.

The government lost two millions of its deposits and in 1840 Congress passed an act establishing a sub-treasury for the deposit of the public funds.

So involved in embarrassments were the financial operations of the period just gone over that it is almost im-possible to ascertain anything in regard to banking capital, circulation, deposits, and specie reserves. The officers of some banking institution were almost entirely ignorant in regard to the business they were conducting. To relieve the distress and restore the convertibility of bank notes laws were passed in some States which had a salutary effect upon these institutions. Among the improvements in the state bank systems the New York systems are worthy of careful consideration. The present national banking system is founded upon the principles of the Free Banking System of New York.

An act was passed in 1829 establishing the Safety Fund System. A common fund was created by contribution, annually, of one-half per cent of the capital of each bank until 3 per cent of such capital was paid in. This fund was made applicable to the payment of the circulation and other indebtedness of any individual bank contributing, which should become insolvent. It was further improved in 1842 when the safety-fund was made applicable only to the payment of circulating notes.

In 1838 the Free Banking System of New York was established and provided that the circulating notes be secured by United States or State bonds deposited at some agency of the bank. Although not perfect the system served to check the inflation against issues of notes that had been practised by the other banks.

Aside from systems of this kind founded in some of the States the state bank system was a medley of makeshifts. They were not founded on real capital, but on the notes of the share-holders, who in turn borrowed the notes of the banks. They kept no adequate reserves of coin and the notes issued in one State were not receivable in the other States.

Every device was practised to prevent the notes from running for redemption. The States exercised no control over them by a proper supervision of officers. When the Civil war broke out the banks were in a state of suspension, but even under these trying circumstances they were constantly increasing their issues. By an act passed March 3, 1865 a tax of 10 per cent was imposed on the issues of the State banks, which put an end to the issue of paper money by the States through banking corporations. The privilege of issuing bills of credit has ever since been withheld from the States and a sounder circulating medium has been secured.

The costly experience of three-quarters of a century suggested a sounder future financial policy which our statesmen and financiers were not slow in adopting.

Secretary Chase in his report of December 1861, recommended the gradual issue of national bank notes on the same basis as the New York system, but his suggestions were not acted upon by Congress at that session.

In the meantime the issue of legal tender notes had been so great as to result in the suspension of specie payments. The limit had been reached, and when this expedient had been found to be fruitless, the act of 1863 authorising the establishment of a national bank was passed. The bill was thoroughly revised, discussed, and repassed June 3, 1864.

The effect upon the public credit was speedily apparent. Bonds advanced from 93 to par in currency and no serious difficulty was found during the remainder of the year in providing for the enormous expenditures of the government.

The act of 1864 was thoroughly guarded by wholesome laws at all the points of danger indicated by previous experience. Some of these laws may first be considered before proceeding to a discussion of the merits and the future of the national banking system.

The act authorized the establishment of a national bank bureau of the Treasury and the Comptroller of the Currency was made the chief officer. Notes were made receivable by the government in payment of taxes and other dues except imports, of debts except interest on the public debt and money employed in the redemption of national bank notes.

Many abuses had occured under the old banking system from lack of capital and it was provided by the act that the capital of every national banking association should be fully paid in. Money cannot be loaned on real estate or on the security of the shares and of their own circulating notes or legal tender notes and accomodation loans cannot be made to an amount exceeding one tenth of the capital. Thus it will be seen that note-holders and depositors are alike protected. To avoid the occurrence of mismanagement examinations are periodically made to see that the necessary securities are on hand. The old system lacked a system of inspection by officers of the government.

The rate of interest charged by the banks is restricted to the rate of the state in which they are located.

Reports showing the condition of any bank may be called for at any time and covering any past time, and must be returned not less than five times each year. This publicity is an effectual safeguard (so far as effectual safeguard is possible) against mismanagement.

Circulation is taxed one per cent annually and a tax of one-half of one per cent is put upon average deposits and capital not invested in United States bonds.

The law requires that each association shall, before the declaration of any

dividend, carry to its surplus fund one-tenth of its semi-annual net profit until the same shall amount to 20 per cent of its capital stock.
Capital cannot be withdrawn either in the form of dividends or otherwise and losses and bad debts must be deducted from net profits.
The estimated loss to the people from the destruction of notes and from failure to present for redemption is about one per cent which is a gain to the government and not to the banks as is erroneously supposed, because the law provides that the banks shall deposit collateral with the Treasurer for the redemption of such notes.
The period that each bank is allowed to continue is twenty years from

date of organization. Each bank is governed by a board of five directors who must own at least ten shares each of stock unencumbered by debt. Three-fourths of these directors must be residents of the State in which the bank is established. Any violation of law with their knowledge makes them liable to shareholders for losses.

Fifty thousand dollars is the maximum of bonds required and if the bonds depreciate an additional deposit must be made to make the notes perfectly secure.

Banks with a capital of 50 to 500 thousand dollars receive 90 per cent of bonds in notes; those with a capital of 500 thousand to one million 80 per cent; those with a capital of 1 to 3 millions

75 per cent; and those with a capital of 3 millions and over, 60 per cent.

(3) Thus it will be seen that the comparatively small capitalists in large cities have an advantage over the wealthy capitalist, and the currency cannot at the same time concentrate in financial centres.

Prior to 1871 the aggregate state and national taxes levied upon banks amounted to 4 1/2 per cent. Since that time it has been 3 1/2 per cent. The banks have, therefore, borne their share of the public burden.

(3) The crisis of 1873 is the only crisis in our history that has not brought on a bank panic and this was due to the stability of the national banking system. National bank

notes have been paid dollar for dollar and the average annual loss to creditors has been very much less than in the case of other banks.

This has been possible because of the perfect laws by which national banks are governed.

Speculation is not countenanced, but legitimate business interests are protected. The few failures that have occurred were occasioned either by criminal mismanagement on the part of the officers or by neglect or violation of the law on the part of the directors. The dangers from these causes are, as we have seen, reduced to a minimum by the perfect system of inspection by public officers of the affairs of the banks.

There are many reasons, overlooked by those who are unable to propose a better system, why the national banking system is deserving of great credit. The government legal tenders were resorted to as a temporary expedient for the exigencies of a great crisis, and, when they were no longer of assistance, the national banking system came, in the dark hour of need, to avert impending disaster. How well it has succeeded has been abundantly shown by its history.

Had it not been for this system the state banks would have continued, and their issues side by side with the government legal tenders would have made the financial situation simply appalling.

In return for the privileges conferred upon them by the government, national banks have rendered incalculable services. When the country was vacillating between a sound currency and government greenbacks, in the midst of the controversy, the national banks began and accomplished the resumption of specie payments at a great expense to themselves.

The interest on the public debt has been greatly reduced by the funding operations of national banks. The enormous saving to the government in the collection and disbursement of the revenue is due to the valuable assistance rendered by national banks. All this saving is enjoyed by the government and yet we hear that the profits of national banks are enormous. As a matter of fact the profits of national banks have not been greater than the profits derived in any of the great industries of the country. These are some of the advantages enjoyed by the government.

The services rendered by national banks to the public are of equal importance. To all classes they are of equal benefit. We have found by experience that the national bank currency possesses uniformity and is a safeguard against depreciation. What greater service could be conferred upon the capitalist than to secure him in the possession of his property and upon the laboring-man than to protect him against the injury of a false standard of value. And yet the opponents of the system inveigh against it as a heartless and grinding monopoly and in their eagerness to overthrow it are not able to offer a better system.

To the commercial community the system has rendered a service that cannot be over estimated. In reducing the exchange and discount rates it has effected a saving to that class aggregating millions of dollars annually. It is not necessary to multiply statistics to prove that the old state system had a directly opposite tendency.

The national banking system has been objected to as a monopoly.

This is far from the truth.

The right to organize a banking association is just as free as the right to form a manufacturing or other business association. The bonds are always in the market and anyone with capital can purchase them and organize a national bank. Therefore the objections made to the early national banks, that they were monopolies, do not apply to the present system.

It has been objected, again, that the right to determine the volume of the currency ought not to be surrendered to private associations. But since the volume of currency depends upon the demands of the business community who have a better right to determine the volume than business men?

It is significant fact that those who were once most strongly opposed to the system at its beginning have become its best friends and supporters.

We do not claim that the system is perfect but experience will continue its suggest, as it has in the past, improvements in its details. Yet in its fundamental features it has already received the high commendation of foreign financiers and statesmen in addition to the unanimous approval of acknowledged authorities in monetary science in this country. We may at some time devise a better system; but the present system is the best yet devised by the ingenuity of man.

In considering the future of the system it must not be forgotten that the present circulating notes based upon bonds will cease to exist when the national debt has been paid.

It is a saying that goes without question that a national debt is not a blessing and the sooner it is paid off the better for the country thus burdened. This being the case the friends of the national banking system naturally feel some concern in regard to its future. If the national bank act can be still further improved, amended, and qualified, to secure not only note holders, but depositors and share-holders, any proposition looking in that direction will deserve careful consideration.

It is certain, however, that we cannot afford to go back to the currency State laws; and it equally certain that the government cannot properly undertake to furnish a credit currency. Many suggestions and plans have been offered in regard to perpetuating the system. Some of these it would not be possible to adopt, while others would no doubt be practicable.

When bond security has entirely disappeared no other bond security is obtainable. Good State bonds cannot be secured in sufficient amounts to serve as security. Other bonds are not desirable as security for notes, because they do not possess sufficient stability.

It is a sound principle that nothing is justifiable which necessitates more taxation than is needed to carry on the government. For this reason also the national debt cannot be continued according to sound principles of finance.

Bonds, therefore, are out of the question.
It has been proposed that a guaranty be made by all the banks for each others notes, together with a change in the law that would give to note-holders the first on the assets of a failed bank. But this guaranty could not be obtained, as the strong banks in large cities do not care about issuing circulating notes. As an inducement for these banks it has been suggested that the fund from tax upon circulation be made a security for notes. This fund would have to be invested in something; and as it would not be policy to lock it up in gold coin it has been suggested that the fund be deposited in redemption banks at central points —

to be drawn upon only in case of failures. The scheme is feasible because the government does not need the tax upon circulation. On the other hand it may be said that it is not just to require good banks to put up a fund for poor banks. Other plans of a similar nature have been proposed.

It is very difficult to arrive at a plan for the perpetuation of the circulation of national banks, but even if the circulation does come to an end it would be highly desirable to continue the system in its functions of deposit and discount, as the system of inspection by public officers is daily growing better.

In the consideration of this question we must not overlook the fact that the national administration of laws pertaining to banks is better than State administration as we have found by costly experience.

Again it has been said, and with good reason, that the end of the circulation of national banks means the return to either the state bank system or the government paper money. We have found out the merits of national bank notes over either the state bank or the government paper money, and, if the issue is to be made between either of these and the national bank notes, the latter in some form are to be preferred.

If the old traditional habits in regard to paper money still have so firm hold upon the people that it will be impossible to abandon paper money altogether and to resort entirely to honest gold and silver as the only currency, there is but one course left — to adopt as a permanent system the national banking system which has been tried by the stress of war and by the crisis of 1873 and which has been found to be better planned for service than any mechanism of credit heretofore tested in this country.

H.C. Hinds.